 No. 70-305

In the Supreme Court of the United States

OCTOBER TERM, 1971

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

FIRST SECURITY BANK OF UTAH, N.A., ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The memorandum findings of fact and opinion of the Tax Court (R. 163-176)[1] are not reported. The opinion of the court of appeals (R. 182-192) is reported at 436 F. 2d 1192.

JURISDICTION

The judgments of the court of appeals were entered on January 21, 1971 (R. 193). By order dated

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[1] "R." references are to the separately bound record appendix.

April 12, 1971, Mr. Justice White extended the time for filing a petition for a writ of certiorari to and including June 20, 1971. The petition was filed on June 18, 1971, and certiorari was granted on October 12, 1971 (R. 194). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether, pursuant to the authority granted in Section 482 of the Internal Revenue Code, the Commissioner properly allocated to the respondent national banks the commission element of the credit life insurance premiums paid by their borrowers in connection with loans, where respondents offered the life insurance to their borrowers ultimately on behalf of a life insurance company under common ownership and control with respondents.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 61 and 482 of the Internal Revenue Code of 1954, of Section 1.482-1 of the Treasury Regulations on Income Tax (1954 Code), and of Sections 5202 and 5239 of the Revised Statutes are set forth in the Appendix, *infra*, pp. 37-41.

STATEMENT

Respondents, First Security Bank of Utah, N.A., and First Security Bank of Idaho, N.A., are national banks which, during the taxable years in controversy (1955 through 1959), were wholly-owned subsidiaries of First Security Corporation ("Holding Com-

pany"), a publicly-owned bank holding company. Since 1948, in connection with their installment and real estate loan business, respondents have offered to their borrowers credit life, health and accident insurance. This insurance, generally referred to herein as credit life insurance, is single-premium decreasing term insurance on the life of the borrower sufficient in amount at least to discharge his debt if he dies or becomes incapacitated during the term of his loan. (R. 27-29, 163-166.)

From 1948 to April, 1954, the credit life insurance purchased by respondents' customers was written by two independent insurance companies at the prevailing industry rate of $1 per $100 of coverage per year on a decreasing term basis. In keeping with the common industry practice, the premium included a built-in allowance sufficient to provide for the payment of a commission to the lending institution which offered the insurance to its borrowers, and the independent insurers in fact paid commissions, ranging from 40 to 55 percent of the net premiums collected to Ed D. Smith & Sons ("Smith"), a wholly-owned subsidiary of Holding Company. Though engaged in the business of selling life and casualty insurance, Smith was in no way involved in the sales of credit life insurance and did not report the commissions as taxable income. Rather, they were reported by First Security Company ("Management Company"), another Holding Company subsidiary which provided management and accounting services to the related group. (R. 19, 70-71, 104-108, 136, 164-167, 170.)

Late in 1953, American National Insurance Company of Galveston, Texas ("American National"), anticipating that tax preferences and potential profits from credit life insurance sales would cause lending institutions to establish their own credit life insurance subsidiaries, approached Holding Company with a new plan designed to salvage some of the profits for the independent carriers. The plan called for Holding Company to create a life insurance subsidiary which would reinsure the risks of the credit life insurance written by American National for respondents' borrowers. Profits from the business would be retained in the subsidiary for investment. It was anticipated that in its initial years the subsidiary would utilize American National's actuarial, accounting and other operational services on a fee basis and, if successful, ultimately grow into a full-line, direct writing insurance company. (R. 30, 167-168.)

Holding Company adopted American National's plan and in June, 1954, formed a wholly-owned life insurance subsidiary, First Security Life Insurance Company of Texas ("Security Life"). The credit insurance was written by American National at the prevailing industry rate of $1 per $100 coverage per year and was reinsured with Security Life under contracts called reinsurance treaties, under which American National received approximately 15 percent of the premium dollar as compensation for its managerial services. Security Life retained the balance for the assumption of all of the risk under the policies. (R. 165, 168-170.)

Security Life's sole source of business income was "reinsurance premiums," and its reinsurance business

was very profitable. Organized in 1954 with capital and paid-in surplus totalling $37,500, Security Life, by the end of that year, was reinsuring $6.5 million of credit life insurance. By the end of 1959, Security Life was reinsuring $41.3 million of such insurance. Its profit for the period 1955-1959 was more than $1 million. (R. 168, 170-171.)

Unlike the unrelated companies which wrote credit life insurance for respondents' borrowers prior to April, 1954, Security Life never paid a commission. As a result, after all expenses (including American National's fee) it was able to retain 52.5 percent of the total premiums. In addition to American National's fee, Security Life's expenses consisted primarily of bank charges, taxes and claim settlement expenses. Forty percent of the net premiums would have been a reasonable sales commission on the business covered by the reinsurance treaties and, had Security Life paid such a commission, it still would have realized an underwriting profit of approximately 12.5 cents on each premium dollar. (R. 108, 126-127, 170-171.)

Respondents had numerous banking offices and maintained a routine procedure for offering credit life insurance to their borrowers. Initially, a loan officer, when interviewing a loan applicant, explained the availability and function of credit life insurance and, if the customer desired the insurance, the loan officer provided the necessary application forms. The borrower then completed the application forms and, upon receipt of the executed application, respondents' personnel issued a certificate of insurance and either

collected the premium from the customer or added it to his loan. Respondents' employees then forwarded the completed forms and premiums to Management Company, which made records of the insurance purchased and forwarded the forms and premiums to American National. Management Company also performed the necessary paper work when claims were filed under the policies. The cost to respondents of processing the credit life insurance purchased by their borrowers for the five years in issue was $8,929 and $9,826, respectively. The cost to Management Company of processing the insurance during the same period was $10,150. (R. 166, 169-170.)

Section 5202 of the Revised Statutes (Appendix, *infra*, pp. 39-40) authorizes national banks located in places having 5,000 or fewer inhabitants to act as insurance agents and receive commissions from soliciting and selling insurance. Section 5239 of the Revised Statutes (Appendix, *infra*, p. 41) provides criminal sanctions for any violation of the federal banking laws. From the time respondents began offering credit life insurance to their customers in 1948, their officers and those of Holding Company have believed that it would be contrary to federal banking law, and thus invite the threat of criminal sanctions, for respondents to receive income resulting from their customers' purchase of such insurance. They did not believe, however, that it would be unlawful to solicit, sell and process the insurance. Accordingly, respondents have never actually received commissions or reinsurance premiums resulting from such purchases; rather, the commissions and rein-

surance premiums have always been paid to corporations under common ownership with respondents—specifically, to Smith from 1948 to April, 1954, and to Security Life thereafter. (R. 166-167, 172.)

Security Life included the entire amount of reinsurance premiums received in its income for 1955-1959. Because the income of life insurance companies is subject to a lower effective tax rate than that of ordinary corporations,[2] this resulted in a smaller total tax liability for Holding Company and its subsidiaries than if a portion of the reinsurance premiums had been included in the income of respondents or Management Company. (R. 168, 170-172; Ex. BR-41.)

Section 482 of the Internal Revenue Code of 1954 (Appendix, *infra*, p. 37) empowers the Commissioner to allocate gross income among "two or more organizations, trades, or businesses * * * owned or controlled directly or indirectly by the same interests * * * if he determines that such * * * allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations * * *." Acting under this provision, the Commissioner determined that 40 percent of the premium income received and included in gross income by Security Life during the years 1955 through 1959 was allocable to respondents, and determined deficiencies

[2] Both the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36, applicable to the years 1955-1957, and the Life Insurance Company Income Tax Act of 1959, P.L. 86-69, 73 Stat. 112, applicable to later years (see Sections 801-820 of the Internal Revenue Code of 1954, as amended), accord preferential tax treatment to life insurance companies. See *United States* v. *Atlas Ins. Co.*, 381 U.S. 233.

accordingly.[a] This allocation was to compensate respondents for selling and processing the credit life insurance and thereby to reflect their income clearly. The Commissioner alternatively asserted deficiencies against Management Company by means of a similar allocation of premium income. Both respondents and Management Company sought redeterminations of the deficiencies in the Tax Court. (R. 172-175.)

That court held that the case was controlled by its reviewed decision favorable to the government (two judges dissenting) in *Local Finance Corp.* v. *Commissioner*, 48 T.C. 773, affirmed, 407 F. 2d 629 (C.A. 7), certiorari denied, 396 U.S. 956, and sustained the Commissioner's determination that 40 percent of the premium income was allocable to respondents. It accordingly did not reach the question of the Commissioner's alternative allocation. (R. 174-176.) Respondents appealed, and the Commissioner took a protective cross appeal for review of the decision favorable to Management Company. The Tenth Circuit reversed the decisions of the Tax Court against respondents, holding (R. 191) that the Commissioner's allocation was "arbitrary and capricious and inconsonant with the basic concepts of federal income taxation," and also reversed the decision of the Tax Court for Management Company. It remanded the case for further consideration of the Commissioner's alternative allocation. (R. 192.)

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[a] Of course, if the Commissioner's determination is sustained, Security Life's income would be reduced by the amount of income allocated to respondents. See Treasury Regulations on Income Tax (1954 Code), Section 1.482-1(d)(2).

SUMMARY OF ARGUMENT

A

Section 482 of the Internal Revenue Code provides that where two or more business organizations are owned or controlled by the same interests, the Commissioner of Internal Revenue may allocate gross income between them if he determines that an allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of the commonly controlled entities. The purpose of this broad delegation of authority by Congress to the Commissioner, as revealed in the legislative history and reiterated in the pertinent Treasury Regulations and court decisions, is to prevent the shifting of profits and resultant distortion of income between commonly controlled businesses by placing them on a tax parity with uncontrolled concerns.

The inquiry to be made in every case arising under Section 482 is whether transactions between commonly controlled parties have taken place on terms comparable to those which would have occurred in arm's length dealings between unrelated parties. If this standard is not satisfied, the Commissioner may, by allocating income or deductions, restore the related parties to what he believes their position would have been if they had dealt at arm's length. It is well-settled that the Commissioner's determination under the arm's length standard must be sustained unless shown to be unreasonable, arbitrary, or capricious.

B

The holding below denies the Commissioner the power to allocate gross income under Section 482 in a situation where it is patent that commonly controlled taxpayers have not dealt with each other at arm's length. Any realistic application of the arm's length standard would permit the Commissioner to make an allocation where one member of a commonly controlled group renders services to another member for less than an arm's length charge. That is precisely what occurred here. Respondents offered and sold credit life insurance to their borrowers on behalf of a commonly controlled life insurance company, but did not charge a fee for their services. Yet, under well known industry practice, it is common for a credit life insurance company to pay generous commissions to a lender which solicits business and performs other selling and processing services. In years prior to the formation of their life insurance affiliate, respondents performed identical selling services for independent insurers, and those companies did pay commissions. It follows that in any arm's length arrangement, respondents would have been compensated for their services, and, accordingly, that the Commissioner was fully justified in allocating commission income to respondents in order to reflect their income clearly.

Despite the foregoing, the court of appeals concluded that respondents could not be taxed on the commissions because they did not receive them or earn them, but only generated the business or income. Emphasizing that respondents never directly received insurance-related income from independent insurers,

the court held that even in uncontrolled dealings, respondents would not have realized taxable income from their sales of credit life insurance. And, the court also held that since respondents were prohibited by federal banking law from receiving commissions, and at all times attempted to comply with federal banking law, it was unreasonable for the Commissioner to allocate commissions to them, and thereby place them in violation of law. All these rulings misconstrue Section 482.

C

Neither the fact that respondents never physically received the commissions, nor the conclusion that they did not "earn" commission income can mask the demonstrable reality that respondents did not deal with their commonly controlled insurance company in an arm's length manner. Obviously, the application of Section 482 is not dependent on the receipt of income, for an allocation of gross income thereunder presupposes that the income was not received, but rather diverted by the taxpayer to a commonly controlled affiliate. The question whether a taxpayer has "earned" or only generated income may be crucial in cases involving general principles of tax law, but it is not necessarily critical for purposes of Section 482. Rather, we submit that the Commissioner has the power to allocate compensation whenever one controlled taxpayer has rendered services to another controlled taxpayer for less than an arm's length charge.

D

It does not follow from respondents' failure physically to receive commissions from independent insurers in earlier years that they realized no taxable income from their uncontrolled dealings. On the contrary, since the pre-April, 1954 commissions were paid to another Holding Company subsidiary, Smith, even though it had nothing to do with the sales of credit life insurance, it is apparent that respondents did not deal with Smith at arm's length. Clearly, if Smith had been an unrelated party, respondents would not have allowed it to receive the commissions. An allocation of such commissions to respondents therefore would have been permissible under the same principles which we urge are applicable to the years here in controversy.

E

The apparent prohibitions of federal banking law do not immunize respondents from an allocation under Section 482. According to their own interpretation of that law, they may lawfully solicit and sell credit life insurance, but may not actually receive commissions arising from their activities or report such commissions as taxable income. Even if their interpretation is correct, and even if they structured their activities to comply with the banking law, the fact remains that they rendered the services for which commissions were paid, and that those services would have been compensated if rendered to an unrelated insurer. This is enough, as a matter of federal tax law, to sustain an allocation of commission income

to respondents, and it is federal tax law, not federal banking law, which controls tax liability.

The Commissioner's allocation does not force respondents to violate the federal banking law. It was they, not the Commissioner, who chose to solicit and sell credit life insurance at a rate set at a sufficiently high level to permit the payment of commissions. If their activities did not violate the banking law, the Commissioner's allocation will not, of itself, constitute a violation on their part. And, surely, the payment of taxes would not be an illegal act.

ARGUMENT

THE COMMISSIONER PROPERLY ALLOCATED TO THE RESPONDENT NATIONAL BANKS, PURSUANT TO SECTION 482, THE COMMISSION ELEMENT OF THE CREDIT LIFE INSURANCE PREMIUMS PAID BY RESPONDENTS' BORROWERS

A. Introduction: The arm's length standard

The facility with which trades or businesses may be organized, as well as the many business and tax advantages to be achieved in using more than one business organization, have frequently encouraged taxpayers to proliferate the number of entities used to conduct what is basically a single economic enterprise. The use of such commonly controlled business organizations makes it possible for owners of multiple trades or businesses to manipulate intercompany transactions so as to reduce tax liability. Even in the absence of tax avoidance motives, common control can foster a considerable amount of arbitrary shifting of income or deductions between related taxpay-

ers. See generally, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, Sec. 15.01, *et seq.* (3d ed., 1971).

To avoid some of these consequences, Congress, since the very earliest days of our income tax history, has provided a variety of legal weapons for limiting the use and abuse of commonly controlled trades or businesses. The statutory provision at issue here, Section 482 of the Internal Revenue Code of 1954, is a continuation of prior law enacted to permit the Commissioner "to deny [to taxpayers] the power to shift income * * * arbitrarily among controlled corporations, and to place such corporations rather on a parity with uncontrolled concerns." *Central Cuba Sugar Co.* v. *Commissioner*, 198 F. 2d 214, 216 (C.A. 2); see also *Eli Lilly and Co.* v. *United States*, 372 F. 2d 990, 1000 (Ct. Cl.). First enacted as Section 45 of the Revenue Act of 1928, c. 852, 45 Stat. 791, 806, the statute was designed "to prevent evasion [of taxes by related taxpayers] (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability." H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16-17; see also S. Rep. No. 960, 70th Cong., 1st Sess., pp. 24-25.

In applying Section 482, it is settled that the touchstone is "that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." Treasury Regulations on Income Tax (1954 Code), Section 1.482-1(b)(1) (Appendix, *infra*, pp. 38-39); *Oil Base, Inc.* v. *Commissioner*, 362 F. 2d 212, 214

(C.A. 9), certiorari denied, 385 U.S. 928; *Baldwin-Lima-Hamilton Corp.* v. *United States*, 435 F. 2d 182, 185 (C.A. 7). In other words, the arrangements contrived by the controlling taxpayer among its several business entities must be tested by what those arrangements would have been if the businesses were not commonly controlled. If the related parties have not acted as they would have in identical, but uncontrolled, arm's length dealings, the Commissioner is empowered to make an allocation pursuant to Section 482.[4] Moreover, because the Commissioner has been given broad discretion to appraise a particular fact situation in making a Section 482 allocation, the courts have uniformly held that his determination is not to be set aside unless clearly shown to be unreasonable, arbitrary and capricious.[5]

There is no dispute among the parties regarding the existence or applicability of these fundamental

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[4] The arm's length standard has long been embodied in the Treasury Regulations interpreting Section 482 and its predecessors (see Treasury Regulations 86, Article 45-1; Treasury Regulations 111, Section 29.45-1; Treasury Regulations 118, Section 39.45-1) and has been adopted by the courts (see, *e.g.*, *Borge* v. *Commissioner*, 405 F. 2d 673 (C.A. 2), certiorari denied, 395 U.S. 933; *Commissioner* v. *Chelsea Products*, 197 F. 2d 620, 623 (C.A. 3); *Simon J. Murphy Co.* v. *Commissioner*, 231 F. 2d 639, 644 (C.A. 6); *Davis* v. *United States*, 282 F. 2d 623 (C.A. 10); *Eli Lilly and Co.* v. *United States*, 372 F. 2d 990, 1000 (Ct. Cl.)).

[5] *G. U. R. Co.* v. *Commissioner*, 117 F. 2d 187, 189 (C.A. 7); *Ballentine Motor Co.* v. *Commissioner*, 321 F. 2d 796, 800 (C.A. 4); *Spicer Theatre, Inc.* v. *Commissioner*, 346 F. 2d 704 (C.A. 6); *Rooney* v. *United States*, 305 F. 2d 681 (C.A. 9); *Grenada Industries, Inc.* v. *Commissioner*, 17 T.C. 231, 255, affirmed, 202 F. 2d 873 (C.A. 5), certiorari denied, 346 U.S. 819.

rules for judging the propriety of a Section 482 allocation.[6] Respondents recognize (Br. in Opp. 10), as they must, that the standard of "an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer" (Treasury Regulations on Income Tax (1954 Code), Section 1.482-1(b)(1)) has been "universally adopted." And the court of appeals, although rejecting the Commissioner's allocation, purported to adhere to the arm's length standard (R. 186-187, 191).

B. The Commissioner's allocation was proper because respondents rendered services for a commonly controlled corporation, without charge, for which they would have been compensated had the parties been dealing at arm's length

The facts leave no room for doubt that during the taxable years in question respondents rendered services for their commonly controlled affiliate, Security Life, without charge, for which they would have been compensated had the parties been dealing at arm's length. Indeed, one need not search far to ascertain the precise amount of the commission income properly allocable to respondents. Common practice in the credit life insurance industry and the fact that independent insurers paid commissions prior to the formation of Security Life graphically demonstrate the correctness of the Commissioner's determination that 40 percent of the "reinsurance premiums" received

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[6] There is likewise no dispute that respondents, Holding Company and all of its affiliates were commonly controlled trades or businesses within the meaning of Section 482 during the taxable years in controversy.

by Security Life (*i.e.*, the commission element) was alloeable to respondents.

1. *In an arm's length transaction an unrelated insurer would have paid commissions*

It is undisputed that during the years in issue, respondents' borrowers paid for credit life insurance at the prevailing industry rate of $1 per $100 coverage each year (R. 170). The evidence also shows (R. 108, 126-127), and the courts have recognized, that the industry-wide premium rate is sufficient to allow insurers to pay sizeable commissions to the lender which solicits the business and sells the insurance. See *Local Finance Corp.* v. *Commissioner*, 48 T.C. 773, 786, affirmed, 407 F. 2d 629, 631-632 (C.A. 7), certiorari denied, 396 U.S. 956; *Alinco Life Insurance Co.* v. *United States*, 373 F.2d 336, 337-338 (Ct. Cl.); *Liston Zander Credit Co.* v. *United States*, 276 F. 2d 417, 423-424, n. 15 (C.A. 5). Finally, as the Seventh Circuit observed in *Local Finance Corp.* v. *Commissioner*, *supra*, 407 F. 2d at 632, "[i]t is well known that insurers pay solicitors a portion of the premium as a commission for generating and processing the insurance." See also R. 105-106. These facts, in and of themselves, are sufficient to demonstrate that if respondents had been dealing with an unrelated insurance company during the years in issue, instead of with their commonly controlled affiliate, Security Life, the unrelated insurer would have paid commissions.

Any argument to the contrary is foreclosed by respondents' own experience prior to the formation of

Security Life in 1954. From 1948 to April, 1954, respondents offered credit life insurance to their borrowers, just as they did during the years in issue, and the independent insurers paid commissions ranging from 40 to 55 percent of the premiums collected. Unlike the independent companies, Security Life paid no commissions. In consequence, it was able to retain, after payment of death claims, more than 59 percent of the net premiums received during the period in question, a percentage far greater than an independent company would have realized on the sale of credit life insurance.[7] Given these facts, there is no basis for any conclusion except that—tested by the arm's length standard—Security Life's income was inflated as a result of the inclusion therein of the commission element of the insurance premiums (as well as the underwriting element), and that an allocation was appropriate to reflect its income clearly.[8]

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[7] For example, American National, the seventh largest stock life insurance company in the United States at the time of the trial of this case, operated on a profit margin of less than five percent (R. 25, 33). As for respondents' contention below that Security Life could not afford to pay commissions because it would become actuarially unsound, it is sufficient to note the Tax Court's observation (R. 174-175) that this disability resulted from Security Life's unusually low initial capitalization. Moreover, Security Life's alleged need to retain its cash is undercut by its 1959 dividend distribution of almost $400,000 to its parent company (R. 50, 171). At all events, Security Life's need for capital cannot displace the implicit requirements of Section 482 that, for tax purposes, it must pay a related corporation arm's length compensation for services rendered.

[8] All of the parties clearly understood that, under the reinsurance arrangement with American National, the amount

2. *In an arm's length transaction respondents would have been compensated for their services*

To what entities related to Security Life is the commission element of the insurance premiums allocable under Section 482? That is the only question remaining once it is seen that commissions would have been paid in an arm's length transaction. In our view, this question is not difficult to answer—the commissions should be included in the income of respondents, since they "performed those minimal [but crucial] services which were the *sine qua non* of the insurance business." *Local Finance Corp.* v. *Commissioner*, *supra*, 407 F. 2d at 633. On the record in this case, there can be no doubt on this score. Respondents advised debtors of the opportunity to obtain insurance; they provided the necessary forms; they issued certificates of insurance; and they collected the premiums for the insurer (R. 169). In short, they did what was necessary to sell the insurance.

Respondents' experience prior to the formation of Security Life again precludes a contrary argument, for the undisputed facts are that they were compen-

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retained by Security Life (85 percent of the total premiums) included a commission. Replying to Holding Company's question (R. 129-130) whether a clause should be inserted in the reinsurance treaties providing for the payment of commissions if Security Life ceased to reinsure the risks, American National wrote (R. 131) that, in such circumstances, "an agency contract will be executed with an agency of your selection whereby American National pays a commission on any accident and health premiums being held by American National." American National further advised (R. 131) that "[f]or very good reasons, this matter cannot be mentioned in a reinsurance treaty * * *."

sated by the independent insurers for the services they rendered. Since they were not compensated when they rendered identical services to Security Life, their income—tested by the arm's length standard—was understated as a result of the exclusion therefrom of the commission element of the insurance premiums, and an allocation was appropriate to reflect their income clearly.

That was the result reached in *Local Finance Corp.* v. *Commissioner*, *supra*, the only other precedent directly in point. There, a majority of the full Tax Court and the Seventh Circuit sustained the Commissioner's power to allocate the commission element of insurance premiums from an insurance company to a related lending institution which had solicited the insurance business, but diverted the commissions to the insurer. Moreover, the allocation of gross income in cases where a lender diverts profits to a so-called "captive life insurance company" was specifically approved by Congress in connection with the enactment of the Life Insurance Company Tax Act of 1955, c. 83, 70 Stat. 36. At that time, both congressional tax-writing committees, recognizing the obvious potential for abuse through the arbitrary shifting of income from a lending institution which solicits insurance business to a related insurance company which enjoys preferential tax treatment, stated their understanding that Section 482 provided the Commissioner with ample regulative authority to deal with problems analogous to the problem presented

here. H. Rep. No. 1098, 84th Cong., 1st Sess., p. 7; S. Rep. No. 1571, 84th Cong., 2d Sess., p. 8.

The fact that respondents did not deal with Security Life as they would have dealt with an independent insurer is, we submit, dispositive of this case. The court below thought otherwise. It concluded that the Commissioner was without power to allocate any part of the commissions or reinsurance premiums to respondents because they did not *receive* them (R. 188, 190-191) or *earn* them (R. 190-191), but only *generated* the business or income (R. 189-191). The court also held that since respondents did not physically receive commissions (other than as a conduit) when they dealt with unrelated insurers, they would not have realized taxable income even in uncontrolled dealings, and, therefore, the Commissioner could not allocate commissions to them when they dealt with Security Life (R. 188, 191). Finally, the court accepted respondents' principal argument (Br. in Opp. 11) that the Commissioner's allocation was unreasonable because federal banking law prohibited them from receiving commission income from credit life insurance sales, and because they structured their activities in such a manner as to comply with that law (R. 187-188; 190-191). We turn now to these aspects of the case.

C. The Commissioner may allocate commission income to respondents even if they neither received nor "earned" such income

In holding that respondents' failure to receive commissions during the years in issue somehow disabled the Commissioner from allocating income to them,

the court below misinterpreted Section 482. Application of that section is not dependent on the receipt of income. See *Asiatic Petroleum Co.* v. *Commissioner*, 79 F. 2d 234, 236 (C.A. 2), certiorari denied, 296 U.S. 645. On the contrary, an allocation of gross income thereunder presupposes that the income was not received by the taxpayer which has so arranged its affairs as to divert the income to another.

Nor is the question whether respondents "earned" the income determinative under Section 482. The court of appeals' conclusion to the contrary (R. 190-191) mistakenly substitutes for the arm's length standard applicable under Section 482 one test for determining to whom income is taxable under Section 61 of the Code (Appendix, *infra*, p. 37). That section provides, to the extent pertinent here, that "gross income means all income from whatever source derived, including * * * [c]ompensation for services, * * * fees, commissions, and similar items * * *." Subsumed thereunder are an amalgam of principles forged by this Court which hold that income is taxed to the true earner thereof (*Lucas* v. *Earl*, 281 U.S. 111), and that the exercise of power to dispose of income and procure the payment of it to another is the equivalent, for federal tax purposes, of the realization of income (*Helvering* v. *Horst*, 311 U.S. 112). It is true, as both the Tax Court and Seventh Circuit recognized in *Local Finance Corp.* v. *Commisioner*, *supra*, that application of the arm's length standard under Section 482 may on occasion involve the same considerations arising in Section 61

cases.[9] See also *Rubin* v. *Commissioner*, 429 F. 2d 650 (C.A. 2); Bittker and Eustice, *supra*, Sec. 15.06. But it does not follow that the two sections are identical in scope or outlook, for "concepts employed in construing one section of a statute are not necessarily pertinent when construing another with a distinguishable background."[10] *Rohmer* v. *Commissioner*, 153 F. 2d 61, 65 (C.A. 2), certiorari denied, 328 U.S. 862.

If, as the court below implied, Section 482 is merely a specific vehicle for applying Section 61 principles to commonly controlled taxpayers, the provision is superfluous, at least insofar as allocations of gross income are concerned. Our submission is that Section 482 should not be so construed, and that, although it incorporates principles developed under Section 61, it is broader in scope, and permits the Commissioner to reallocate income whenever related parties have not

[9] For this reason, the Commissioner often predicates tax deficiencies on both Sections 61 and 482 and has done so in this case (R. 163). While under the facts here we believe that respondents "earned" the commissions, at this juncture our reliance is solely on Section 482.

[10] As the Third Circuit has explained (*National Securities Corp.* v. *Commissioner*, 137 F. 2d 600, 602, certiorari denied, 320 U.S. 794):

> In every case in which the section [*i.e.*, Section 482] is applied its application will necessarily result in an apparent conflict with the literal requirements of some other provision of the act. If this were not so Section * * * [482] would be wholly superfluous. We accordingly conclude that the application of Section * * * [482] may not be denied because it appears to run afoul of the literal provisions of * * * [other sections of the Code].

dealt with one another as they would have if they had been unrelated. Compare *Rubin* v. *Commissioner*, *supra*, with *Maxwell Hardware Co.* v. *Commissioner*, 343 F. 2d 713 (C.A. 9); see also Tannenwald, J. concurring in *Local Finance Corp.* v. *Commissioner*, *supra*, 48 T.C. at 799. For example, if employees of Security Life had been stationed in respondents' various branches in order to sell credit life insurance, an allocation may well have been warranted, since, in an arm's length arrangement, an independent insurer would have been required to pay a fee for the use of respondents' premises and the opportunity to conduct its insurance business on those premises. Therefore, the conclusion reached below (R. 190) that respondents did not "earn" commission income, and hence could not be taxed, because their services required minimal effort and negligible cost, cannot conceal the facts that it was they and no one else who rendered the essential services, and that such services would have commanded compensation if rendered to an unrelated party.[11]

Finally, the error in the court of appeals' reasoning is compounded by its assumption (R. 189) that "[t]he position of the Commissioner in effect is that whoever generates income must include the amount thereof in his gross income", and its concomitant rejection of the allocation on the ground that (R. 191) "[g]eneration of business is not enough to impose federal income tax liability." It is unclear precisely what the court meant when it said that respondents

[11] Similarly, since the Commissioner's allocation was to compensate respondents for selling and processing insurance, the fact that they had no underwriting risk, relied upon by the court of appeals (R. 190), is irrelevant.

only "generated" the income. This is not simply a case involving a diversion of a corporate opportunity or the mere channelling of profitable business from one corporation to another. Respondents performed all of the usual selling and processing services which under credit life insurance industry practice entitle a lender to generous compensation. Thus, to the extent that the decision below is premised on the assumption that respondents only generated the income, it erroneously disposes of the Commissioner's allocation on the basis of a non-existent hypothetical set of facts.

The more fundamental analytical fallacy in the reasoning below lies in the court's apparent view that the Commissioner was imposing a "[g]eneration of income" standard (as opposed, presumably, to a who "earned the income" standard) in determining whether to allocate income under Section 482. In fact, he was imposing neither of these standards. The subtle distinction between earning and generating income has been deemed critical only in the determination of taxability under Section 61. A Section 482 allocation, on the other hand, turns on the entirely different question whether the income of related entities has been distorted because they dealt with each other on a non-arm's length basis.[12]

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[12] For this reason, the court of appeals' comment (R. 189), that generation of income differs from assignment of income (see, *e.g.*, *Crowley* v. *Commissioner*, 34 T.C. 333, 345), is beside the point. Likewise beside the point are cases like *Teschner* v. *Commissioner*, 38 T.C. 1003, which hold, under Section 61, that generation of income does not give rise to taxable income to the generator. Similarly, the court's qualms (R. 190) that acceptance of the "generation of business

D. The failure of respondents physically to receive commissions when dealing with unrelated insurers is no bar to the Commissioner's allocation.

Respondents contend (Br. in Opp. 10-12) and the court below held (R. 188, 191) that since they did not physically receive commissions in arm's length transactions with unrelated insurers prior to April, 1954 —other than as a conduit—they did not realize taxable income from the prior transactions. On the basis of this premise, respondents argue that because they had no commission income in dealings with unrelated insurers, the Commissioner is powerless to allocate commission income to them resulting from their dealings with Security Life.

This argument is incorrect because the premise on which it rests is incorrect. It is true that pre-April, 1954 commissions were paid to Smith, another Holding Company subsidiary. But the fact that they were paid to Smith, rather than to respondents—even though respondents solicited the insurance business and Smith had nothing to do with it—demonstrates that although respondents dealt with the unrelated insurers on an arm's length basis they did not deal similarly with Smith. For this reason, an allocation of commissions from Smith to respondents would have been permissible under Section 482 or its predecessor, if Smith had included the commissions in its income. Smith did not do so, however—the commis-

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theory" will have "alarming consequences on normal commercial practices such as all types of referral business and security commission giveups" are unfounded. Section 482 does not apply to normal commercial transactions between unrelated entities, but only to abnormal transactions between commonly controlled entities.

sions were reported as income by Management Company.[13]

The fact of respondents' non-receipt in the earlier years, then, far from advancing their case, highlights Holding Company's power to designate which of its subsidiaries would receive commissions and which would report them for tax purposes. It also emphasizes the need for a Section 482 allocation to prevent the arbitrary shifting of income among controlled corporate entities. It manifestly does not establish the arm's length standard by which respondents' dealings with Security Life are to be judged.

Moreover, if the arm's length standard is to be determined by reference to receipt and non-receipt in the earlier years, as respondents apparently claim, the bizarre and untenable conclusion is that the Commissioner may allocate the income in question only to Smith, despite the fact that it had no substantive connection with either the earlier or later transactions. Even this argument is not open to respondents, however, for the reporting practices of the Holding Company affiliated group show that it at no time has considered the fact of receipt as the touchstone of taxability.

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[13] The Commissioner's failure in the earlier years to allocate commissions from Management Company to respondents is, of course, no bar to a correct determination for the years here in issue (see *Travis* v. *Commissioner*, 406 F. 2d 987, 990 (C.A. 6); *Massaglia* v. *Commissioner*, 286 F. 2d 258, 262 (C.A. 10); cf. *Automobile Club of Michigan* v. *Commissioner*, 353 U.S. 180), particularly since the total tax liability of the Holding Company affiliated group would, in those years, have been the same whether or not an allocation was made.

E. The apparent prohibitions of federal banking law on respondents' receipt of income from the sale of insurance do not preclude the Commissioner's allocation

1. *Federal banking law*

Sections 5202 and 5239 of the Revised Statutes provide that a national bank may act as an insurance agent in any place "the population of which does not exceed five thousand inhabitants * * *" and apparently prohibit national banks, under threat of criminal sanctions, from acting as insurance agents in places having a population of more than 5,000. Respondents do not interpret these statutes as prohibiting them from offering life insurance at the industry-wide premium rate (which contains a built-in commission factor), or from performing all of the services necessary to sell such insurance. Rather, respondents read the statutes as barring them only from receiving the commission income and reporting it on their income tax returns.[14] Because of these pro-

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[14] There has been some question whether Section 5202 of the Revised Statutes remains in force. Because the provision was omitted from the 1918 amendment and reenactment of Section 5202 of the Revised Statutes by Section 20 of the War Finance Corporation Act, c. 45, 40 Stat. 506, 512, the revisers of the United States Code have omitted it from editions of the Code, subsequent to the 1946 edition, on the theory that it was repealed in 1918. The implicit statutory proscription is, however, incorporated in the Comptroller of the Currency's current Regulations as 12 C.F.R. 2.1-2.5. It is also not entirely settled whether respondents' interpretation of the prohibition is correct. In 1963, the Comptroller of the Currency held (R. 187; Ex. AV) that a national bank in a place with a population exceeding 5,000 could receive income

hibitions on physical receipt, respondents contend (Br. in Opp. 11, n. 6) that they remained aloof from any "entitlement" to insurance-related income, and (Br. in Opp. 12) that the Commissioner, by his allocation, is forcing them to "violate a law" which they have in good faith been attempting to respect.

We accept respondents' representation that their understanding of federal banking law prompted them to structure their affairs so as to remain aloof from the receipt of insurance-related income. Acceptance of their argument that they may not be taxed, however, would accord tax reality to formalistic arrangements which taxpayers devise only to comply with federal or state law requirements based on policy considerations wholly unrelated to Section 482. We submit that even if the arrangements adopted by respondents were required to, and did, satisfy the federal banking law, the question under Section 482 remains whether—applying the standard of arm's length bargaining—respondents' income was clearly reflected during the years when they rendered selling and processing services for Security Life. The answer to this question turns on federal tax law, not on federal banking law, and under the former, illegal gains, like legal gains, are taxable whether received or not. Compare

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from selling credit life insurance if such income was closely related to the bank's normal lending activities. See 12 U.S.C. 24 (Seventh). The Fourth and Fifth Circuits, construing the law in other contexts, subsequently indicated otherwise (see *Commissioner* v. *Morris Trust*, 367 F. 2d 794 (C.A. 4); *Saxon* v. *Georgia Ass'n of Independent Ins. Agents, Inc.*, 399 F. 2d 1010 (C.A. 5)), and the court below apparently followed their decisions (R. 187).

James v. *United States*, 366 U.S. 213, with *Bailey* v. *Commissioner*, 52 T.C. 115, 119, affirmed *per curiam*, 420 F. 2d 777 (C.A. 5), and *Geiger's Estate* v. *Commissioner*, 352 F. 2d 221 (C.A. 8), certiorari denied, 382 U.S. 1012.

2. The Commissioner may allocate commissions to respondents even though they structured their affairs to comply with their interpretation of federal banking law

Respondents concede (Br. in Opp. 11) that federal or state prohibitions on the receipt of income do not preclude the taxation of illegal income if it is received. They argue that since the existence of the federal banking law caused them consistently and in good faith to remain removed from any entitlement to commission income, they would not have received such income even in dealings with unrelated insurers, and, in fact, did not receive commissions prior to April, 1954. We have already shown (pp. 21-22, 26-27, *supra*) that the fact of non-receipt in the earlier, as well as the later, years is no bar to the Commissioner's allocation. Respondents' attempt to use their alleged compliance with the law as a shield against application of the arm's length standard is no different in substance from the argument, rejected long ago by this Court, that a taxpayer may not be taxed on income which he cannot legally claim as his own. See *Lucas* v. *Earl, supra;* see also *James* v. *United States, supra.*

Even though respondents never physically received commissions, they unquestionably rendered the services for which commissions were paid, and their deal-

ings with Security Life were significantly different from their prior dealings with independent insurers. Clearly, respondents would not (and did not, prior to April, 1954) allow an independent insurer to retain that portion of the premiums representing a built-in allowance for commissions. The only reason that the arrangement with Security Life was countenanced by respondents was because the companies were under common control. To hold the Commisioner powerless to apply Section 482 under these circumstances merely because a commonly controlled group has been able to divert income in supposed compliance with federal or state law would frustrate the purpose of the statute.[15]

3. ***The allocation does not force respondents to violate the banking law***

Respondents also maintain (Br. in Opp. 12) that the Commissioner's allocation is unreasonable because it forces them to violate a law which they have been attempting to respect. If respondents have violated the banking law, however, it is their own actions, not the Commissioner's allocation, which would trigger the indictment. The Commissioner has never forced

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[15] Respondents likewise cannot escape the allocation because their dealings with Security Life did not involve tax-avoidance motives. The grant of power to the Commissioner to allocate under Section 482 is in the disjunctive and either a tax-avoidance motive or a failure to reflect clearly the income of the controlled organizations will support an application of the statute. *Asiatic Petroleum Co.* v. *Commissioner, supra; Eli Lilly and Co.* v. *United States, supra; Philipp Brothers Chemicals, Inc.* (N.Y.) v. *Commissioner*, 435 F. 2d 53 (C.A. 2); *Dillard-Waltermire Inc.* v. *Campbell*, 255 F. 2d 433, 436 (C.A. 5).

respondents to engage in selling and processing activities akin to those of an insurance agent, but only to reflect their income clearly. In any event, respondents could have avoided both their federal banking law problems and their federal tax dilemma simply by offering credit life insurance to their borrowers at a lower rate, which did not include the built-in commission factor common in the industry. Security Life still could have realized the standard underwriting profit, and respondents would have fostered their expressed goal (R. 166) of obtaining the benefits of additional collateral which credit insurance provided. Indeed, by charging a lower rate, respondents might well have attracted more loan customers and thereby increased their profits.

Respondents rely heavily (Br. in Opp. 12-13) on a line of authorities presumably standing for the proposition that good faith efforts by the taxpayer to comply with the law must be recognized and sustained. None of these authorities enunciates the broad proposition that good faith efforts to comply with the law preclude the application of Section 482. Many of them are inapposite because they involve the particularized fact question whether a controlling shareholder-officer was selling insurance on behalf of his corporation or in his capacity as a separate insurance agent.[16] Others do not involve Section

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[16] *E.g., Moke Epstein, Inc.* v. *Commissioner*, 29 T.C. 1005; *Ray Waits Motors* v. *United States*, 145 F. Supp. 269 (E.D. S.C.); and *Jaeger Motor Car Co.* v. *Commissioner*, 284 F. 2d 127 (C.A. 7), certiorari denied, 365 U.S. 860, each involved holdings that the efforts of an individual officer compelled the

482.[17] Although *Campbell County State Bank, Inc.* v. *Commissioner*, 37 T.C. 430, reversed on other grounds, 311 F. 2d 374 (C.A. 8), refers to a state law prohibiting banks from engaging in the insurance business, the law was regarded as relevant only to show some business purpose (other than the saving of taxes) for the formation of a separate taxable entity to sell insurance. The law was not construed to preclude application of Section 482.

L. E. Shunk Latex Products, Inc. v. *Commissioner*, 18 T.C. 940, does not stand for the proposition that the legal right to receive income is a necessary prerequisite to the application of Section 482. In *Shunk*, the Tax Court held that an allocation was unreasonable because the price charged by the taxpayer to its controlled distributor was fixed by Office of Price Administration limits. The pivotal fact there was that the taxpayer could not have raised its price even to an uncontrolled distributor; the O.P.A. price levels established a *de jure* arm's length price such that even in uncontrolled dealing, the taxpayer would have been forced to forego the economic benefit attributed by the Commissioner. Here, on the other hand, respondents' own interpretation of federal banking law (which we accept *arguendo*) made it possible to per-

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finding that he, rather than his controlled corporation, had earned commission income. Here, it cannot seriously be contended that respondents did not expend the necessary effort to become entitled to the portion of credit life insurance premiums representing commissions.

[17] *E.g., Nichols Loan Corp.* v. *Commissioner*, 21 T.C.M. 805, reversed on other grounds, 321 F. 2d 905 (C.A. 7).

form insurance-selling services and divert their compensation to Security Life, and as their experience in prior years demonstrates, they would not have forfeited the economic benefit of commission income had Security Life been an unrelated insurer.

In sum, none of the foregoing cases, erroneously characterized by the court below (R. 190) as "indistinguishable" from "the standpoint of principle", supports setting aside the Commissioner's Section 482 allocation, either on the ground that federal banking law prohibited respondents from receiving commission income or on any other ground. The Commissioner's determination here was based on the plain and simple fact that respondents and Security Life, by failing to deal at arm's length, were able to shift income properly attributable to respondents. The allocation was therefore appropriate "to prevent evasion of taxes" and "clearly to reflect the income" of both respondents and Security Life. Under these circumstances, neither the prohibitions of federal banking law nor the fact that respondents structured their affairs to circumvent that law can justify abandoning the arm's length standard and upsetting the allocation.

CONCLUSION

For the reasons stated, the judgments of the court of appeals should be reversed.

Respectfully submitted.

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NOVEMBER 1971.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 61. GROSS INCOME DEFINED.

(a) *General Definition.* Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

* * * *

SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any such organizations, trades, or businesses.

Treasury Regulations on Income Tax (26 C.F.R.):

Sec. 1.482-1. *Allocation of income and deductions among taxpayers.*

(a) *Definitions.* When used in this section * * *

* * * *

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.*—

(1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions,

credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

* * * *

(c) *Application.*—Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

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Revised Statutes:

SEC. 5202 [as amended by Section 1, Act of September 7, 1916, c. 461, 39 Stat. 752]. * * *

* * * *

That in addition to the powers now vested by law in national banking associations organized

under the laws of the United States any such association located and doing business in any place the population of which does not exceed five thousand inhabitants, as shown by the last preceding decennial census, may, under such rules and regulations as may be prescribed by the Comptroller of the Currency, act as the agent for any fire, life, or other insurance company authorized by the authorities of the State in which said bank is located to do business in said State, by soliciting and selling insurance and collecting premiums on policies issued by such company; and may receive for services so rendered such fees or commissions as may be agreed upon between the said association and the insurance company for which it may act as agent; and may also act as the broker or agent for others in making or procuring loans on real estate located within one hundred miles of the place in which said bank may be located, receiving for such services a reasonable fee or commission: *Provided, however*, That no such bank shall in any case guarantee either the principal or interest of any such loans or assume or guarantee the payment of any premium on insurance policies issued through its agency by its principal: *And provided further*, That the bank shall not guarantee the truth of any statement made by an assured in filing his application for insurance.

[12 U.S.C. (1946 ed.) 92.]

SEC. 5239.

If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions

of this Title all the rights, privileges, and franchises of the association shall be thereby forfeited. Such violation shall, however, be determined and adjudged by a proper district or Territorial court of the United States in a suit brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation.

[12 U.S.C. 93.]

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No. 70-305

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1971

COMMISSIONER OF INTERNAL REVENUE, PETITIONER
v.
FIRST SECURITY BANK OF UTAH, N.A., ET AL

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF ON BEHALF OF BUD KOUTS CHEVROLET COMPANY, WESLEY H. KOUTS AND MARGARET E. KOUTS, HIS WIFE AS AMICUS CURIAE IN SUPPORT OF RESPONDENTS

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